# Threats to Central Bank Independence

# Threats to the Central Bank?

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# 1832 and 2010

**Andrew Jackson, veto message**

- “It is to be regretted that the rich and powerful too often bend the acts of government to their selfish purposes…. Many of our rich men have not been content with equal protection and equal benefits, but have besought us to make them richer by act of Congress.”

**Ron Paul, *End the Fed* (2009)**

- “In the United States, the central bank is the Federal Reserve, the instrument by which our money and credit are constantly manipulated for the benefit of a privileged class…. We could stop the Fed bailout of its friends on Wall Street.”

## Congress created central banks in 1791 and 1816
## Congress abolished the first in 1811
## Jackson vetoed Congress's bill to extend the second in 1832

- Principles: The Banks of the United States were not "necessary and proper", and therefore unconstitutional

- Interests: Without a central bank, state banks would:
  - Get rid of a regulator
  - Get rid of a large competitor
  - Likely garner the federal government's banking business

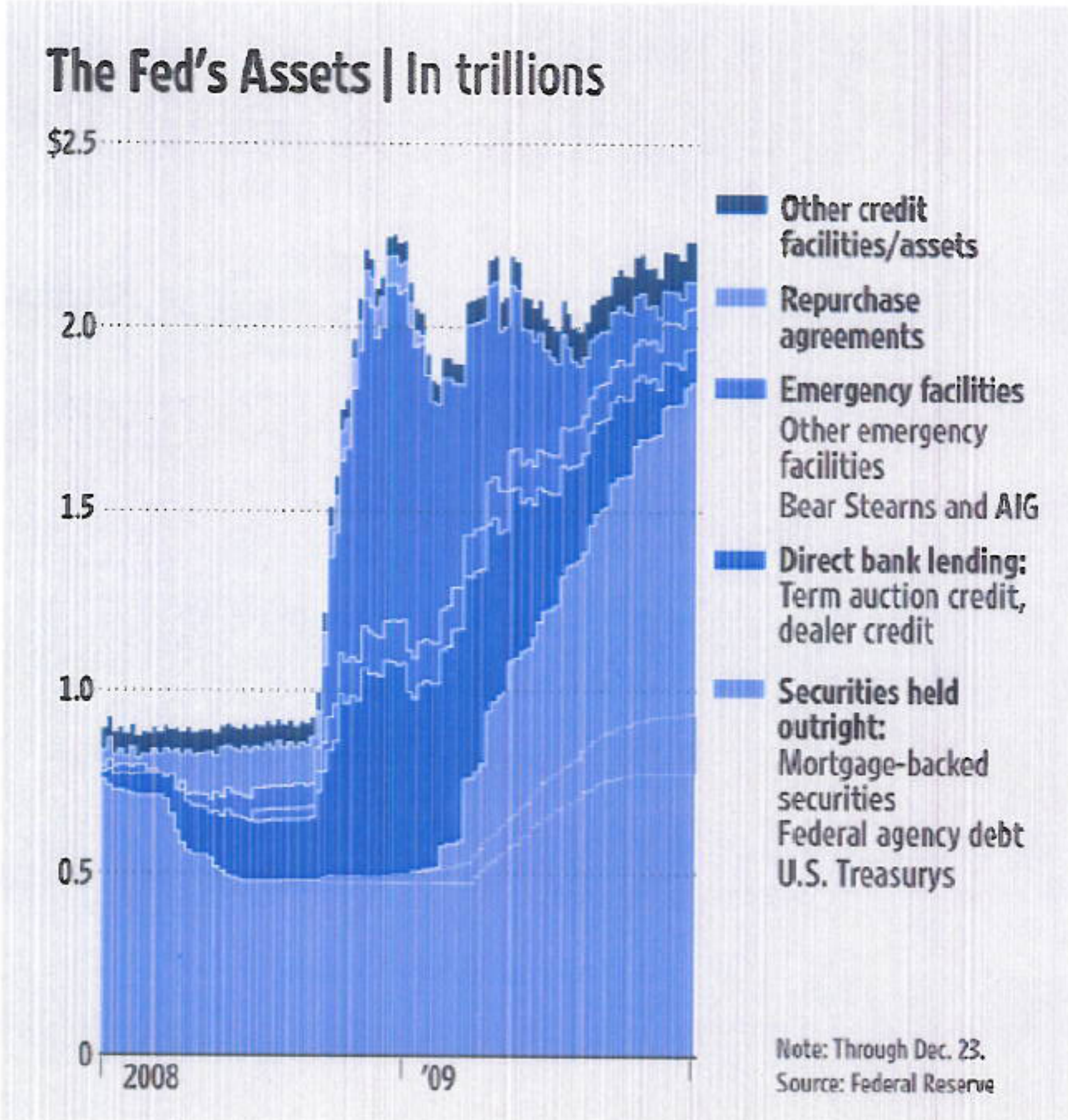
# The Fed

- Regulates banks
- Has the federal government's banking business
- But it does not compete with private financial institutions…or did not until recently

**Federal Reserve Balance Sheets, 2007 (Dec. 31) and 2010 (Jan.)**

**December 2007 ($ billion)**

| **ASSETS** | | **LIABILITIES** | |
|---|---|---|---|
| US Treasury Secs | 835.7 | Fed. Res. Notes | 791.7 |
| Cash items. etc. | 80.5 | Reverse repos | 44.0 |
| Bank premises | 2.1 | Deposits (reserves) | 38.8 |
| Other | 6.9 | | |
| | | Capital & surplus | 36.9 |
| Total | 918.3 | | 918.3 |


The Fed's Assets | In trillions
$2.5
2.0
1.5
1.0
0.5
0
2008
'09
Other credit facilities/assets
Repurchase agreements
Emergency facilities
Other emergency facilities
Bear Stearns and AIG
Direct bank lending:
Term auction credit, dealer credit
Securities held outright:
Mortgage-backed securities
Federal agency debt
U.S. Treasurys
Note: Through Dec. 23.
Source: Federal Reserve

**January 2010 ($ billion)**

| ASSETS | | LIABILITIES | |
|---|---|---|---|
| US Treasury secs. | 776.6 | Fed. Res. Notes | 878.4 |
| Fed. Agency debt | 163.7 | Reverse repos | 57.8 |
| Mortgage-backed secs. | 969.7 | Deposits (reserves) | 1,246.3 |
| Term auction credit, loans | 126.4 | Other | 15.5 |
| Net portfolio holdings* | 73.7 | | |
| Preferred interests** | 25.1 | Capital & surplus | 52.3 |
| Other assets*** | 115.0 | | |
| Total | 2,250.3 | | 2,250.3 |

*Maiden Lane I, II, III LLCs, TALF LLC

** AIA Aurora LLC, ALICO Holdings LLC

*** Assets denominated in foreign currencies, accrued dividends on preferred interests (**)

# Walter Bagehot’s LOLR rules, 1873 (independently formulated by Alexander Hamilton in 1792)

- “The end is to stay the panic; and the advances should, if possible, stay the panic. And for this purpose, there are two rules:--First. That these loans should only be made at a very high rate of interest….
- Secondly. That at this rate these advances should be made on all good banking securities, and as largely as the public ask for them…. If it is known that the Bank of England is freely advancing on what in ordinary times is reckoned as a good security—on what is then commonly pledged and easily convertible—the alarm of the solvent merchants and bankers will be stayed.”

Walter Bagehot, *Lombard Street* (1873)

# Skating on thin ice?

- Instead of lending <u>to the market</u> on good collateral at very high rates, the Fed recently lent on dodgy collateral at very low rates <u>to particular firms</u>
- As the crisis wanes, the assets on the Fed balance sheet make it vulnerable to the charge that it is <u>competing with private financial firms</u>
- Should an ‘independent’ central bank channel capital to particular sectors (federal agencies, banking, housing, insurance, autos indirectly?) and particular firms (Bear/ JPMorgan Chase, AIG)? Is that part of its mandate?
- Is this playing into the hands of Ron Paul, whose audits—in the House bill—are just a first step to “End the Fed” (see his book)?

# Parallels?

- Jackson lost to Adams in 1824 (despite getting more votes), was damn angry, won in 1828, and got rid of the central bank in 1832

- (A la Krugman), Palin lost in 2008, is damn angry, . . .